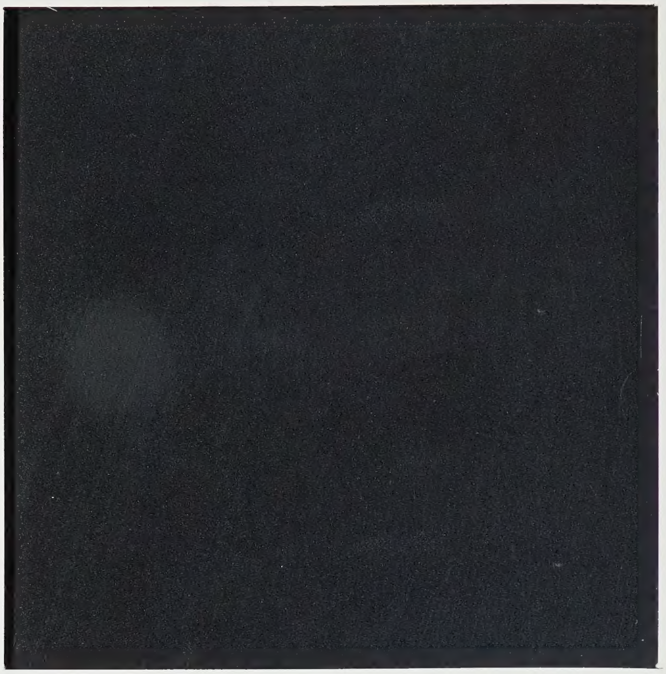
SMALL BUSINESS ADVOCACY REPORT NO. 9

THE ONTARIO INVESTMENT NETWORK

April, 1986

MINISTRY OF INDUSTRY, TRADE AND TECHNOLOGY
ONTARIO



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Small Business Branch
Small Business, Service Industries
and Capital Projects Division
Ministry of Industry, Trade and
Technology

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THE ONTARIO INVESTMENT NETWORK

AN INNOVATIVE APPROACH TO SMALL BUSINESS RISK CAPITAL FORMATION

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It has become increasingly apparent in recent years, particularly as a result of the 1982-83 recession, that many small businesses in Canada suffer from a shortage of equity capital. The impacts of this "equity gap" are serious:

- Small businesses have an excessive reliance on bank debt, much of it short-term. This greatly increased their vulnerability to fluctuations in interest rates and the level of economic activity. During the recession, when interest rates were at their cyclical peak, almost every dollar of cash flow generated by small businesses was required to service bank debt. Although the situation has improved since then, small businesses are still disproportionately burdened by short-term bank debt. This increased the small business failure rate. Although such failures are a normal and necessary aspect of the economic system, an excessive failure rate acts as a damper on economic growth and as a strong disincentive to new business formation.

- Small businesses in Canada are at a disadvantage in competing with their counterparts in the United States where small business tends to be less highly leveraged. The less risky financial structure of U.S. small businesses allows them to take greater non-financial risks in the form of more aggressive research and development, price competition and penetration of new markets. The relatively high financial leverage of Canadian small businesses will definitely limit their competitiveness in a free-trade environment.

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- Small businesses in Canada are at a disadvantage in competing with their counterparts in the United States where small business tends to be less highly leveraged. The less risky financial structure of U.S. small businesses allows them to take greater non-financial risks in the form of more aggressive research and development, price competition and penetration of new markets. The relatively high financial leverage of Canadian small businesses will definitely limit their competitiveness in a free-trade environment.

- It is becoming increasingly difficult for potential entrepreneurs to establish new enterprises. Since the recession, bankers have been far more circumspect in granting credit unless supported by a solid equity base. The lack of availability of this equity is now a serious hindrance to business start-up, where even a few years ago a start-up could be achieved with very little equity. While this change is healthy from a fiscal management point of view, it has potentially serious consequences for new job creation given that almost all new jobs in Canada are created by small businesses.

The Ontario government has devoted considerable effort to improving the ability of business owners to gain access to equity capital. Ontario successfully advocated that Canadian private companies be eligible investments for Registered Retirement Savings Plans. Through the province's Small Business Development Corporations program investors have received significant incentives to invest in Ontario manufacturing, tourism and book publishing. Recently the government has widened the range of eligible business. The government now sees the need for an efficient mechanism to help bring entrepreneurs and potential investors together and enable them to take advantage of the available vehicles and incentives.

In summary, the recession highlighted the inadequate equity base of Canadian business in general and small business in particular.

The post-recession business environment is far less permitting of an equity deficiency. Unless existing and prospective small businesses can find more equity, their existence will be threatened, their ability to compete diminished, and their capacity to create new jobs reduced.

The Cause

There has been quite extensive research in recent years on the reasons for the equity deficiency of small business in Canada. While, to some extent, the equity gap results from a lack of demand due to the entrepreneur's concerns about dilution of control, there is evidence of a supply problem. A survey of small business financing conducted by Price Waterhouse in 1985 on behalf of the federal Department of Finance indicated that the greatest difficulty is experienced by businesses and potential businesses seeking equity of $50,000 to $500,000. Less than $50,000 can usually be mobilized by an entrepreneur from personal assets or from those of family and friends. For amounts over $500,000, the conventional venture capital community is prepared to seriously evaluate a potential investment. For less that $500,000 the venture capitalist cannot afford to spend the necessary time to evaluate and manage the investment.

There is a supply of risk capital for the $50,000 to $500,000 range of investment. This supply is made up of informal investors who are unaffiliated with any investing institution. Typical informal investors are wealthy individuals, particularly

those who have made their wealth through their own entrepreneurial endeavours, as well as wealthy professionals and those with inherited wealth. It has even been estimated that the supply of informal risk capital far exceeds the institutional risk capital supply.

If a supply of informal risk capital exists, why is it not mobilized? Research has established that the informal risk capital market operates very inefficiently because effective mechanisms do not exist to make suppliers and seekers of capital aware of each other. Certainly investments <u>are</u> made through personal contacts. Some of the more successful Canadian high technology enterprises were initially financed in this manner. However, this is a very "hit and miss" process, and relies on accident or chance. Bankers, lawyers and accountants attempt to play a matchmaking role but this is also limited in scope to each organization's limited range of contacts.

The inefficiency of the informal risk capital market in Canada was a key factor behind a number of the measures in the 1985 federal government. The $500,000 capital gains tax exemption and the freeing up of retirement capital pools for investment in small business were both intended to make more informal risk capital available to small businesses. However, these measures do not address the need for specific mechanisms to channel informal risk capital into small businesses in order to produce increased investment. Venture capital clubs have been established in Toronto, Montreal

and Edmonton, but these are limited in scope and lack the credibility of broad-based community support.

Thus the challenge for the private sector is to create viable, solid mechanisms to increase the flow of informal risk capital into small businesses. These mechanisms must be credible, accessible and inexpensive, and must operate within the securities laws.

THE OPPORTUNITY

The Ontario Chamber of Commerce and the Government of Ontario have collaborated on the development of a new mechanism to improve access to equity capital called the Ontario Investment Network; it addresses precisely the "equity gap" that is known to exist for small businesses.

The Ontario Investment Network would be operated by the Ontario Chamber of Commerce as a non-profit enterprise. Below are main attributes of the Network.

- It would consist of a computerized data base of entrepreneurs and investors whose needs are compared against a set of criteria to generate "matches".

- The entrepreneurs and investors would be added to the data base through application by the individuals themselves and through referral by a network of intermediaries (bankers, lawyers and accountants).

- The Network would play no screening or investment advisory role, with the result that no problems are anticipated with securities legislation.

- The Network would maintain strict confidentiality of all registrants in the data base. All matches are communicated only to the relevant investors who can decide whether or not to follow-up. If the investor does so, the Network would send the investor a summary of the entrepreneur's business plan. If the investor is still interested, the Network would arrange a meeting between the parties and play no further part in the process.

- The Network can be instrumental in attracting investment capital from foreign sources.

THE ROLE OF GOVERNMENT

The Government of Ontario has shown a strong commitment to create an environment in which small businesses can thrive and emerging business can move toward their full potential. Through its three development corporations and through the Small Business Development Corporation (SBDC) program, the Ontario government significantly assists small businesses to obtain adequate financing.

The Ontario Investment Network would complement the province's existing small business programs. In particular it would increase the flow of equity capital through SBDC's into small businesses. The province would be able to refer entrepreneurs to the Network as well. In all likelihood, the three development corporations would be a major source of referrals.

The Ontario government would:

- refer entrepreneurs to the Network;

- contribute $100,000 towards promotional costs at the start-up stage;

- establish the legality of the initiative by statement of policy from the Ontario Securities Commission; and

- develop "how to" guides on ways to structure equity investments and offer counselling support to entrepreneurs by field staff of the Ministry of Industry, Trade and Technology on aspects of business management.

The Network would also help bring to life the vehicles recently created by the federal government to encourage investment in small business. The Small Business Investment Limited Partnership and Small Business Investment Trust are useful vehicles for pooling RRSP funds, but are of limited use without a mechanism for finding good investment opportunities.

Perhaps the most attractive aspect of the Network from a government point of view is that it would be independently operated by the Ontario Chamber of Commerce and once fully operative, would be financially self-sufficient.

In summary, the Network would be an excellent example of the private sector establishing an independent, self-sufficient vehicle complementing government incentives and programs.

THE ROLE OF THE ONTARIO CHAMBER OF COMMERCE

The Network would be a program of the Ontario Chamber which would:

- promote the Network;
- provide the staffing, space and computer facilities;
- process applications at its 160 offices across the province;
- perform the matching process; and
- communicate matches to the affected parties.

It is critical to the success of the Network that it be operated by a credible, not-for-profit business organization with broad-based community support. Both entrepreneurs and investors would be comfortable that the OCC is genuinely interested in fostering economic development, and does not have any vested interest in encouraging inappropriate matches. Participants would also have assurance that confidential information is not disclosed other than in the manner contemplated by the program. Potential investors, in particular, will not wish their identities to be disclosed to unauthorized parties, and will probably be more ready to participate in the program because of the OCC's involvement. Finally, because of its visibility and its strong contacts with all facets of the business community, the OCC would make the Network highly accessible to both investors and entrepreneurs.

For the OCC, the operation of the Network would be an opportunity to provide a much needed service to the business community. The Network would enhance the OCC's standing as an effective promoter of the growth and development of the business community.

IMPLEMENTATION

It is intended that the Network be fully operative in less than six months. The implementation would be performed by the OCC.

Although the implementation will be carried out by the OCC, the Ontario Government will participate by funding the promotional activities needed to make the Network a success. The cost of promotion will be about $100,000.